DEPARTMENT OF STATE REVENUE

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Letter of Findings: 08-0558; 08-0559; 08-0560; 08-0561; 08-0562
Corporate Income Tax
For the Years 2004, 2005, and 2006

NOTICE: Under IC § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Adjusted Gross Income Tax – Royalty Fee & Interest Deductions.

Authority: IC § 6-3-1-3.5(b); IC § 6-3-2-2; IC § 6-8.1-5-1; 45 IAC 3.1-1-8; Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayers challenge the Department of Revenue's decision disallowing royalty expense deductions.

II. Ten Percent Negligence Penalty.

Authority: IC § 6-8.1-5-1(c); IC § 6-8.1-10-2.1(a)(3); IC § 6-8.1-10-2.1(a)(4); IC § 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayers argue that they are entitled to an abatement of the ten-percent negligence penalty on the ground that any tax deficiency was due to reasonable cause and not willful neglect.

STATEMENT OF FACTS

Taxpayers are five related entities in the business of producing, distributing, and marketing food items. The Department of Revenue (Department) conducted an audit review of Taxpayers' records and found that each of the related entities had paid royalties to an intellectual property holding company (hereafter "Holding Company") during the years at issue. The audit noted that the royalty payments substantially reduced the income of the five related entities. The audit concluded that the result was "detrimental to the [Taxpayers'] operating income without any clear benefit other than avoiding state income taxes...." Therefore, the audit disallowed and added back the royalty expenses. Taxpayers disagreed with the decision and filed a protest to that effect. An administrative hearing was conducted during which Taxpayers' representatives explained the basis for the protest. This Letter of Findings results.

I. Adjusted Gross Income Tax – Royalty Fee & Interest Deductions.

DISCUSSION

As mentioned above, the Department's audit addressed the royalty expenses claimed by five different but related Taxpayers. For purpose of this Letter of Findings and for convenience sake only, the terms "Taxpayer" and "Taxpayers" may be interchangeably used and should be read and interpreted in context.

The common thread among the Taxpayers is that they are directly or indirectly involved in the production of food products. Taxpayers arranged to transfer certain intellectual property trademarks to a separate Holding Company. Thereafter, Taxpayers and Holding Company entered into "non-exclusive trademark licensing agreements" whereby Taxpayers licensed the use of the trademarks which they had previously owned. In return, Taxpayers paid Holding Company royalty amounts. Taxpayer maintains that the amount of royalties was determined by means of an "arms-length" evaluation of the trademarks commercial value.

During the years at issues, the Taxpayers collectively paid Holding Company approximately $490,000,000 in royalty fees. In turn, the Holding Company paid Taxpayers approximately $350,000,000 in the form of dividends during the same three years.

The Department, acting under the authority of IC § 6-3-2-2(l), concluded that the royalties deductions taken by Taxpayers on their 2004, 2005, and 2006, Indiana returns distorted Taxpayers' Indiana taxable income so as not to fairly reflect Taxpayers' income derived from sources within Indiana. The Department, therefore, acting under the authority of IC § 6-3-2-2(l), disallowed the royalty deductions. Taxpayers protest the Department's addback of royalty expense to their Indiana adjusted gross income for those years because the deductions, Taxpayers argue, were valid business expenses and therefore properly deductible under federal and Indiana law.

The Department notes that all tax assessments are presumed to be accurate, and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(b), (c); Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

IC § 6-3-1-3.5(b) provides the starting point for determining a taxpayer's taxable income stating that the term "adjusted gross income" shall mean, "In the case of corporations the same as 'taxable income' (as defined in Section 63 of the Internal Revenue Code...." The Department's administrative rules repeats the basic principle at 45 IAC 3.1-1-8 stating that "'Adjusted Gross Income' with respect to corporate taxpayers is 'taxable income' as

defined in Internal Revenue Code – section 63)...." However, the taxpayer's federal "adjusted gross income" is merely the starting point; IC § 6-3-1-3.5(b) thereafter requires that the individual taxpayer make certain additions and subtractions to that starting point, the details of which are not relevant here.

The audit disallowed Taxpayers' royalty and interest deductions under IC § 6-3-2-2(l).

IC § 6-3-2-2 states in relevant part:

(l) If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(1) separate accounting;

(2) for a taxable year beginning before January 1, 2011, the exclusion of any one (1) or more of the factors, except the sales factor;

(3) the inclusion of one (1) or more additional factors which will fairly represent the Taxpayer's income derived from sources within the state of Indiana; or

(4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

(m) In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various Taxpayers.

...

(p) Notwithstanding subsections (l) and (m), the department may not require that income, deductions, and credits attributable to a taxpayer and another entity not described in subsection (o)(1) or (o)(2) be reported in a combined income tax return for any taxable year, unless the department is unable to fairly reflect the taxpayer's adjusted gross income for the taxable year through use of other powers granted to the department by subsections (l) and (m). (Emphasis added).

Taxpayers maintain that the transfer of the intellectual property to the Holding Company was done pursuant to a valid "business purpose" and the transfer – and consequent royalty payments – had an economic substance. Taxpayers explain that the Holding Company was in a better position to police the intellectual property, that the Taxpayers – as the original owners of the intellectual property – were entitled to attach a financial value to that property and were thereafter entitled to receive royalty payments pursuant to an "arm's length" evaluation of the intellectual property. In addition, Taxpayers state that the Holding Company employs three full time employees who "perform extensive quality control testing of [food] products manufactured and distributed under [Holding Company's] trademarks to ensure compliance with trademark quality specifications."

The Department has no quarrel with any of Taxpayers' reasons for transferring the intellectual property, with the three employees' efforts to police the quality of Taxpayers' food products, or with the right of Holding Company to receive royalties in exchange for the services it performs. Taxpayers have shown a facially valid business purpose for their trademark activities. However, notwithstanding this valid business purpose, the economic substance of these royalty deductions does not fairly reflect Taxpayers' Indiana activities since they reduce substantially Taxpayers' Indiana taxable income during the audit years while resulting in an equally substantial tax benefit to participants. Taxpayers paid approximately $490,000,000 in royalty fees to the Holding Company which – in turn – saw fit to return the majority of those fees in the form of dividends. The Department was fully entitled to conclude that such a significant distortion of Taxpayers' taxable Indiana income did not "fairly reflect" Taxpayers' income derived from sources within the state of Indiana during the audit years. Pursuant to IC § 6-3-2-2(l) and (m), the Department is authorized to employ a reasonable method that effectuates an equitable distribution, allocation, or apportionment of income to Indiana. Subject to the bar set by IC § 6-3-2-2(p), the Department was entitled to add back Taxpayers' royalty expense deductions to its Indiana taxable income.

FINDING

Taxpayers' protest is respectfully denied.

II. Ten Percent Negligence Penalty.

DISCUSSION

Taxpayers ask that the Department exercise its discretion to abate the ten-percent negligence penalty on the ground that the additional assessment of tax was not due to willful neglect.

IC § 6-8.1-10-2.1(a)(3) requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. IC § 6-8.1-10-2.1(a)(4) requires a ten-percent penalty if the taxpayer "fails to pay the full amount of tax shown on the person's return on or before the due date for the return or payment."

IC § 6-8.1-10-2.1(d) states that, "If a person subject to the penalty imposed under this section can show that the failure to... pay the full amount of tax shown on the person's return... or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall wave the penalty."

Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined

on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC § 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed...."

Under IC § 6-8.1-5-1(c), "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." An assessment – including the negligence penalty – is presumptively valid.

As much as the Department may disagree with Taxpayers' position on the royalty payments, the Department is prepared to agree that Taxpayers "exercised ordinary business care and prudence" and that judged "on a case-by-case basis according to the facts and circumstances of each taxpayer," the ten-percent negligence penalty should be abated.

FINDING

Taxpayers' protest is sustained.

SUMMARY

Taxpayers' protest is denied as to the imposition of additional corporate income tax as described in Part I of this Letter of Findings. The Department agrees that the ten-percent negligence penalty should be abated.

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